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SUBJECT: JAMAICA: ECONOMIC CHALLENGES FACING THE NEW GOVERNMENT OF PRIME MINISTER BRUCE GOLDING

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Overview

1.(SBU) This first of several cables outlining challenges facing the new Government of Prime Minister (PM) Bruce Golding's Jamaica Labour Party (JLP) focuses on pressing domestic and international economic problems, including:

-- a reemergence of fiscal difficulties;

-- a debt-to-GDP ratio approaching 140 percent;

-- high unemployment and anemic growth;

-- the global credit squeeze;

-- the slow-down in the U.S. economy;

-- and rising international oil prices.

These difficulties-- recently compounded by nearly USD 300 million in damages to Jamaica from Hurricane Dean-- would be disconcerting to any new government-but particularly so to Golding's JLP, which during the election campaign promised free health care and education, faster growth, and job creation. End Overview.

Fiscal Difficulties Resurface

2.(SBU) The reemergence of fiscal difficulties will be the first major challenge facing the incoming government. While figures for the first four months of the fiscal year showed some amount of consolidation, the Ministry of Finance now has revealed that over USD 220 million, or almost two percent of GDP, worth of expenditures are yet to be included in the budget. This is not surprising, as Senior Director of the Fiscal Policy Management Unit Courtney Williams had confirmed EmbOff's view that expenditures could spike after the elections, given the (now well-established) practice of deferred financing. This revelation also bears out the contention of then-Opposition finance spokesman (now Finance Minister) Audley Shaw made during the 2007 budget debate that the Government was presenting an "election budget," and that additional expenditures would emerge thereafter. When the cost associated with the JLP's free tuition promise is added, the fiscal deficit could jump to almost 7 percent of GDP, up from 4.5 percent. (Comment: Given that

the country has been overshooting its fiscal deficit target in recent years, and given the emerging international credit crunch, it thus should come as no surprise if Jamaica's credit rating is downgraded in the upcoming year. End Comment.)

Hurricane Dean Blows Targets Off Track

3.(SBU) The new administration is faced not only with the unenviable job of reshaping the fiscal budget, but also with revising the entire macroeconomic program, given the damage meted out by Hurricane Dean (reftel). Total hurricane damages are estimated at almost USD 300 million, and will have serious implications for economic growth and fiscal consolidation. The economy is projected to slow to only 1.1 percent, down from an already anemic 2.1 percent; this will have negative consequences for tax revenues, which recently have been outperforming programmed levels. Inflation, which recently has slowed to single digits, now is expected to jump to low double digits given the shock of Dean, especially to domestic agriculture. Soaring oil prices also should contribute to a further spike in inflation. (Note: Septel will provide more details on the impact of Hurricane Dean. End note).

Credit Crunch To Affect Funding

4.(SBU) With tax revenues expected to slow, the government will be forced to look to the domestic and external markets for funding. But either approach could have consequences for the economy. Increased domestic borrowing could stymie the central bank's efforts to further reduce interest rates. Domestic borrowing requirements could also crowd out the local private sector, which is expected to

be one of the engines of growth. Sourcing funds on the external market will be no different, particularly given the country's worsening fiscal dynamics and the tightening international capital market, given the credit crunch. But even if funds are available on the external market it will come at a much higher cost and will influence local investors to shift from local to foreign denominated assets. This would place even more pressure on the local currency, forcing the central bank to use more of its reserves to shore up supplies. Demand pressures also will emanate from soaring oil prices now hovering around USD 80 a barrel, well above the USD 71-72 predicated in the economic program. This is sure to put additional pressure on the current account and by extension the local currency as more resources will be required to pay the oil bill. On the supply side, declining tourist arrivals are expected to slow tourism receipts.

5.(SBU) That said, the greatest threat of any increase in rates will be to the fiscal dynamics, as any increase in interest cost will only serve to exacerbate an already tenuous situation. When this is added to the issues of sluggish revenue growth and the JLP's promise to cap both the fiscal deficit and the debt, the challenges facing the new government appear almost insurmountable in the short term. The fiscal dynamic could also be affected if the JLP acts on its promise to make the central bank fully independent-and thus not obliged to make the monetary adjustments necessary to accommodate fiscal profligacy. But fiscal efficacy aside, an independent central bank is important from a rules-based approach. And this policy position should be simple to implement, as the current governor always has supported greater independence for the bank.

6.(SBU) The JLP also has identified funding from multilaterals as a substitute for high cost debt. But while funding from this source has its advantages, it cannot be used for recurrent spending; it also takes time to negotiate and is therefore not a short term solution. Similarly, resources could be garnered by selling state assets but time will also be required to identify the assets to be sold, making this at best a medium term solution. And while loss-making assets like Air Jamaica and the Sugar Company of Jamaica may merit consideration for sale, any decision actually to do so

could turn out to be political dynamite.

Debt to Remain a Drag

7.(SBU) At the end of July 2007, the total stock of debt amounted to USD 14.1 billion or almost 140 percent of GDP, thus maintaining Jamaica's unenviable record as one of the most indebted countries in the world. And this does not even include the stock of publicly guaranteed debt, considered a contingent liability to government, which could push the debt up by another four percent of GDP. Given that debt has the first call on the budget, after the Governor General's remuneration, the cost of financing this gargantuan debt and its attendant effect on the rest of the economy must rank as one of the major challenges facing the new administration. This could explain why the JLP has wooed Grace Kennedy Executive Don Webhy to support Finance Minister Audley Shaw. (Webhy will serve as Minister without Portfolio, but has been explicitly attached to the Finance Ministry.) With debt servicing cost accounting for almost sixty percent of the budget and climbing, the JLP's social spending promises will be challenged. While Shaw had enumerated a number of strategies to address the debt overhang while in opposition, and while the JLP has outlined an ambitious plan to bring down the debt to 100 percent of GDP in its Manifesto, it will realize that the emerging international credit dynamic could make some proposals moot. That said, if the administration is able to make good on its promise to grow the economy and create new jobs, then it could begin to generate the revenues required to pay down the debt. In fact, aside from debt forgiveness (which is unlikely), the only credible way to reduce the debt burden is to grow out of it. As such, Shaw's proposal to use the savings from the PETROCARIBE Agreement, while plausible, can only serve to complement the solution of increased economic growth and by extension revenue growth.

Investment and Growth

8.(SBU) Investment and growth are key planks of the JLP's manifesto. The administration has decided to concentrate on job-creating "greenfield" investment as well as the creation of an offshore financial sector. To enable the rapid private sector

growth needed to create jobs and reduce the fiscal imbalance, the new government is planning to reduce the bureaucracy and corruption that have been Jamaica's major bugbears. But while there is little doubt that growth is manifestly required, the new administration will discover that it will first have to overcome a number of structural bottlenecks that currently limit competitiveness of the Jamaican private sector. Jamaica may lack the capacity to grow by the 5-6 percent enunciated by the JLP due to its chronic shortage of skilled labor. Crime, which is considered the number one problem facing Jamaicans (to be the subject of septel), also magnifies the cost of doing business and will figure prominently in the minds of prospective investors. A 2005 World Bank report, drawing on a survey of 159 firms operating in the region, argued that to improve the investment climate, Caribbean countries must improve their infrastructure (including information and communication technology), policy and legal environment, and taxation and customs; these factors continue to limit investment in Jamaica today. Regarding the offshore financial sector, while Jamaica has natural advantages and a relatively sound regulatory framework, it will have to compete with both existing and emerging players. And while cutting bureaucracy does not require much financial outlay, it might still be difficult to achieve given that bureaucracy benefits stakeholders who will resist losing the associated economic rent. The damage caused by Hurricane Dean, the slow down in global growth, and the prospect of a possible recession in the U.S. also could militate against the growth and investment platform.

Comment

9.(SBU) Given the reemergence of fiscal indiscipline, the new administration might be advised to use the remainder of the fiscal year (which ends March 31, 2008) to concentrate on the implementation of those manifesto items that do not require funding. In this regard, it is expected that the new government will spend the time addressing the legislative framework necessary to improve governance, which has been in need of redress and is actually a prerequisite for some of the investment and growth policies outlined in the manifesto. This may be one reason that the widely respected former opposition spokesman on justice, Delroy Chuck, who has a legal background, now has been named Speaker of the House. But the administration nevertheless will face a number of challenges going forward. Chief among these are the rehabilitation efforts following Hurricane Dean and the attendant effect on the fiscal accounts. The revelation of fiscal indiscipline at the Ministry of Finance can only serve to erode the consolidation which had characterized the last seven months. The new administration's desire to grow the economy by between six and seven percent also will be stymied by the slow-down in global economic activity and in the U.S. economy in particular. This is particularly disconcerting because of the Jamaican economy's heavy dependence on the U.S. economy, particularly in the areas of bauxite, remittances, and tourism. While remittances have proven a most resilient flow of income, during a possible recession tourists tend to stay at home and demand for commodities declines. Jamaica already has seen a fall off in tourist arrivals and an attendant decline in tourism receipts. End comment.

JOHNSON